ST 00-26
Tax Type: Sales Tax
Issue: Audit Methodologies and/or Other Computational Issues

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,		No. 99-ST-0000
	IBT#	0000-0000
		NTL
v.		Periods: 7/1/95 to 6/30/98
JOHN DOE,		**Ted Sherrod**
TAXPAYER		**Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Eric B. Deobler of White, Marsh, Anderson, Vickers & Deobler, for JOHN DOE; John Alshuler, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

This matter comes on for hearing pursuant to a timely filed protest of Notice of Tax Liability No. XXXXX for the tax period 7/1/95 to 6/30/98 issued to JOHN DOE (hereinafter referred to as "Taxpayer") by the Department of Revenue ("Department") on June 2, 1999. A pre-trial order was entered on June 1, 2000, in which the parties stated the issue to be decided as "whether the audit methodology utilized by the Department resulted in an accurate calculation of the Taxpayer's gross receipts for the audit period". Following the submission of all evidence and a review of the record, it is recommended

that this matter be resolved in favor of the Department. In support of this recommendation, I make the following findings of fact and conclusions of law.

Findings of Fact:

1. The Department's *prima facie* case against the taxpayer, inclusive of all jurisdictional elements, was established by the admission into evidence of the SC-10-K Audit Correction and/or Determination of Tax Due ("correction of return") and the Notice of Tax Liability ("NTL") showing a proposed liability in the amount of $59,331 for the tax periods 7/1/95 to 6/30/98. Dept. Ex. 1. [1]

2. The taxpayer is the sole owner of DOE'S TAVERN, a tavern engaged in the sale of beer, wine, liquor, pizza, soft drinks and snacks located in ANYWHERE, Illinois. Tr. pp. 4, 12; Taxpayer's Ex. 1.

3. The taxpayer is also the sole owner of The DOE'S, a restaurant engaged in the sale of beer, wine, liquor, pizza, snacks and other food items located in ANYWHERE, Illinois. Tr. pp. 13, 49, 55; Taxpayer's Ex. 1.

4. Patricia Pond is the wife of the taxpayer. Tr. p. 13.

5. The taxpayer concedes that there is some deficiency in his Retailers' Occupation Tax due for the tax periods. Tr. pp. 8, 58.

6. The Department determined the taxpayer's 1997 Retailers' Occupation Tax liability for unreported sales by establishing the taxpayer's inventory costs for 1997 and including a mark-up of the sales price over the purchase price of the items sold. Tr. p. 6; Taxpayer's Ex. 1.

[1] Unless otherwise noted, findings of fact apply to the tax periods.

7. The Department determined the taxpayer's Retailers' Occupation Tax liability for other tax periods in controversy by projecting forward and back unreported sales as determined for 1997. Tr. p. 6.

8. The taxpayer does not dispute the Department's determination of the taxpayer's inventory costs. Tr. pp. 6, 34, 35; Taxpayer's Ex. 1.

9. In determining the amount of gross receipts it believes should have been reported by the taxpayer, the Department used different mark-up percentages for beer, wine, liquor and pizza. Taxpayer's Ex. 1.

10. The taxpayer did not maintain cash register tapes and other data providing a daily record of the gross amount of sales as required by 86 Illinois Administrative Code, Section 130.805. Tr. p. 5.

11. The taxpayer does not dispute the Department's determination that the inadequacy of its books and records made it necessary to estimate the taxpayer's gross sales. Tr. p. 6.

12. A fraud penalty was imposed pursuant to the auditor's determination that the difference between reported sales and unreported sales amounted to over $528,000 for the audit period. Tr. pp. 5, 6.

13. In its attempt to rebut the Department's *prima facie* case, the taxpayer presented at the hearing its accountant's report which is based upon conversations with the taxpayer, and uses mark-ups from the 1998-1999 edition of RMA Annual Statement Studies and the 2000 edition of the Almanac of Business and Industrial Financial Ratios, with the accountant's report itself showing a significant deficiency. Tr. pp. 8, 10, 11, 56, 58; Taxpayer's Ex. 1.

14. The accountant's report was forwarded to Eric Deobler, the taxpayer's attorney in this case on July 26, 2000. Taxpayer's Ex. 1.

Conclusions of Law:

Pursuant to 35 **ILCS** 120/4, the correction of returns submitted as the Department's exhibit 1 is *prima facie* correct and constitute *prima facie* evidence of the correctness of the amount of tax due as shown thereon. Once the Department establishes the *prima facie* correctness of the amount of tax due through the admission into evidence of the correction of returns, the burden shifts to the taxpayer to show that this determination is incorrect. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988). On examination of the record in this case, I conclude that the taxpayer has not presented sufficient evidence to overcome the Department's *prima facie* case. Accordingly, for the reasons given below, the aforementioned NTL should be affirmed in its entirety.

The Retailers' Occupation Tax Act has a specific requirement for maintaining books and records, which provides as follows:

> Every person engaged in the business of selling tangible personal property at retail in this State shall keep records and books of all sales of tangible personal property, together with invoices, bills of lading, sales records, copies of bills of sale, inventories prepared as of December 31 of each year or otherwise annually as has been the custom in the specific trade and other pertinent papers and documents. 35 ILCS 120/7.

A taxpayer's duty to keep such books and records is mandatory. Smith v. Department of Revenue, 143 Ill. App. 3d 607 (5th Dist. 1986). If the taxpayer does not have adequate books and records to support his monthly tax returns, the Department is

justified in going outside the taxpayer's books and records to obtain information to correct the taxpayer's returns. Young v. Hulman, 39 Ill. 2d 219 (1968).

The method used by the Department in such a case must only meet a minimal standard of reasonableness. Smith, 143 Ill. App. 3d at 611. Moreover, the Department is not required to substantiate the basis for the corrected return. *See* A.R. Barnes & Co., *supra*. Accordingly, proof that an audit determination meets a minimal standard of reasonableness through testimony of the auditor explaining the calculations at the hearing is not required unless a taxpayer has introduced evidence sufficient to rebut the Department's *prima facie* case. *Id*. Hence, the threshold issue presented in this case is whether the taxpayer has presented evidence or testimony sufficient to overcome the presumed correctness of the Department's mark-up calculation used to arrive at the taxpayer's gross sales.

To overcome the Department's *prima facie* case, the taxpayer must present consistent, probable evidence closely identified with his books and records. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968); Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987); Vitale v. Department of Revenue, 118 Ill. App. 3d 210 (3d Dist. 1983); A.R. Barnes v. Department of Revenue, *supra*. The taxpayer attempts to meet this burden through testimony intended to establish that it was impossible for the taxpayer's businesses to attain the profit margins attributed to them by the auditor's calculations (Tr. pp. 63, 64, 66). During testimony, the taxpayer presented no books or records to corroborate his conclusions regarding his estimate of business profit margins. Nor did the taxpayer attempt to base his conclusions on income tax returns, bank records or any other documents related to the business' books and records.

While the taxpayer provides a plausible explanation of why the profit margins of DOE'S TAVERN and The DOE'S were lower than those attributed to these businesses by the Department, this testimony does not show that the auditor's methods for determining the inventory mark-up were unreasonable. Case law in Illinois clearly indicates that merely denying the accuracy of the Department's assessments, offering alternative hypotheses or arguing that its audit methodology is flawed is not enough to overcome the Department's *prima facie* case. A.R. Barnes & Co. v. Department of Revenue, *supra;* Central Furniture Mart v. Johnson, *supra*; Quincy Trading Post Inc. v. Department of Revenue, 12 Ill. App. 3d 725 (4th Dist. 1973). A taxpayer can overcome the Department's *prima facie* case only by producing competent evidence closely identified with the taxpayer's books and records. Copilevitz v. Department of Revenue, *supra;* A.R. Barnes & Co. v. Department of Revenue, *supra;* Central Furniture Mart v. Johnson, *supra*; Vitale v. Department of Revenue, *supra*. In the instant case, the taxpayer has presented no such documentary evidence to show that the Department's determination was arbitrary, capricious or unreasonable. Oral testimony without corroborating books and records is insufficient to overcome the Department's *prima facie* case. Mel Park Drugs v. Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991). The taxpayer's unsubstantiated oral testimony based on the taxpayer's recollections is simply not sufficient to meet the taxpayer's burden in this case. *Id*.

The taxpayer also attempts to rebut the Department's *prima facie* case by introducing into the record the accountant's report. The report is based on the taxpayer's conclusions regarding the mark-up on inventory at DOE'S TAVERN and The DOE'S. Tr. pp. 10, 11, 56; Taxpayer's Ex. 1. It was prepared by Richard R. Virgo, Jr., a

Certified Public Accountant. Taxpayer's Ex. 1. The accountant states that his report shows "(T)he gross profit percentage after taking into account adjustments is approximately 58% for both DOE'S TAVERN and the DOE'S…(T)his figure is nearly identical to the gross profit percentages reflected in the 1998-1999 edition of RMA Annual Statement Studies, and the 2000 edition of the Almanac of Business and Industrial Financial Ratios". Taxpayer's Ex. 1. The cover letter to the accountant's report also indicates that the accountant relies exclusively on the assertions of the taxpayer and his wife as the factual basis for its conclusions, and states "(N)o effort was made, or requested, to determine the accuracy or basis for the assertions made by Ronald and/or Patricia Pond." Taxpayer's Ex. 1.

The cover letter accompanying the accountant's report indicates that the report was mailed only one day before the date of the hearing in this case, and was directed to the attorney representing the taxpayer in these proceedings. Taxpayer's Ex. 1. These facts indicate that this document was prepared in anticipation of the hearing in this matter. Records prepared in anticipation of litigation are not records made in the ordinary course of business and are not admissible into evidence unless they fall within an exception to the hearsay rule. In re A.B., 308 Ill. App. 3d 227 (2d Dist. 1999). However, the Department did not object to the admission of this exhibit.

Hearsay evidence that is admitted without objection may be considered in an administrative proceeding. Jackson v. Board of Review of Department of Labor, 105 Ill. 2d 501 (1985). However, the weight to be given such evidence is completely within the discretion of the hearing officer. *Id*. As previously noted, there is nothing in the record to substantiate the accountant's estimate of the mark-up on product sales at DOE'S

TAVERN and The DOE'S except the taxpayer's testimony and other assertions by the taxpayer and his wife. (Tr. pp. 10, 11, 56; Taxpayer's Ex. 1). Consequently, I give the accountant's report no more weight than the testimony and assertions upon which it is based. *See* Manion v. Brant Oil Co., 85 Ill. App. 2d 129, 136 (4th Dist. 1967) ("It is said that 'naked opinion' unsupported by reason is entitled to little weight and that the weight and value of evidence expressed through opinions largely depends upon the foundations of fact and reason upon which such opinions stand"), Mullen v. General Motors Corp., 32 Ill. App. 3d 122 (1st Dist. 1975), St. Paul Fire & Marine Ins. Co. v. Michelin Tire Corp., 12 Ill. App. 3d 165 (1st Dist. 1973). As noted previously, oral assertions alone are not enough to rebut the Department's *prima faice* case. Mel-Park Drugs, Inc. v. Department of Revenue, *supra*. Only consistent, probable evidence closely identified with books and records accomplishes this. A.R. Barnes & Co. v. Department of Revenue, *supra*; Vitale v. Department of Revenue, *supra*; Copilevitz v. Department of Revenue, *supra*; Central Furniture Mart v. Johnson, *supra*. Because the accountant's report is completely based on oral testimony and statements, and is not corroborated in any way by anything connected to the taxpayer's books and records, I find that the accountant's report is not sufficient to rebut the Department's *prima facie* case.

WHEREFORE, for the above stated reasons, it is my recommendation that NTL XXXXX for the periods 7/1/95 to 6/30/98 be affirmed in its entirety.

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Ted Sherrod

Administrative Law Judge

Date: September 22, 2000